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SUBJECT: GSL BUDGET "NOT AS BAD AS WE THOUGHT;" BUSINESSES EXPRESS RELIEF

REF: A. A) COLOMBO 1858

¶B. B) COLOMBO 1171
¶C. C) COLOMBO 490

¶1. (SBU) Summary: Finance Minister Amunugama presented the GSL's 2005 budget proposal to Parliament on November 18. The budget included a number of provisions to expand revenue collection, widen the tax base and numerous new spending initiatives aimed primarily at the public sector, the rural sector and Small and Medium Enterprises (SME). On the revenue front, VAT has been expanded to three tiers, corporate tax deductions were cut and fees and tax surcharges were increased. Some reforms were offered for the Department of Inland Revenue, but fell short of the dramatic overhaul that had been pushed by the previous Government. On the expenditure front, the budget includes funding for a new SME "bank," assistance to the apparel sector (anticipated in light of the pending removal of quotas in January), infrastructure projects and a significant salary increase for public sector employees (as well as funding to hire an additional 30,000 high school grads into public sector jobs). The GSL proposes to increase revenue collection from 15% of GDP to 19% over four years. It has also pledged to roughly halve the deficit by 2008. While overall commentary on the budget has been largely positive, much of it falls into the category of "it's not as bad as we thought." Opposition criticism has been muted. The budget continues to send the signal that it is government, rather than the private sector, which should be the engine of economic growth. At a time when the GSL needs to be focused on increased trade competitiveness and showing that it is "open for business," the budget does nothing to address either requirement. Perhaps having completed a "home grown" budget, something the GSL saw as a political necessity, it will now attempt to reach out more widely to donors, the IFIs and the international community as it moves into implementation. End Summary.

¶2. (U) During his November 18 presentation of the GSL's 2005 proposed budget to parliament, Finance Minister Sarath Amunugama criticized the previous United National Party (UNP) Government's reforms as skewed against the rural poor and small and medium sized enterprises (SME's) and for having a heavy urban focus. Amunugama claimed the United People's Freedom Alliance (UPFA) budget was a response to its election victory in April and had been widely consulted, taking input from over 1100 citizens.

¶3. (U) Anxiety had run high prior to the budget submission, particularly in the business community. Most observers believed heavy new taxes, despite recently imposed revenue measures (Ref A), would be accompanied by significant new spending priorities, including increases in social welfare payments and subsidies. In the end, however, the budget was less troubling to business than predicted. Though there is a clear move toward greater import substitution policies and enhanced revenue collection, the budget also had targeted spending increases and an emphasis on the need to cut the budget deficit (projected to be 8.6% of GDP in 2004).

Macroeconomic Projections

¶4. (U) The UPFA's maiden budget aims to raise revenue from 15.6% of GDP currently to 17.2% in 2005. Its ultimate goal is revenues equivalent to approximately 19% of GDP.

¶5. (U) The previous GSL had made cutting the deficit a high priority and lowered the deficit from over 10% of GDP in 2001, to a projected 7.6% in 2004. 2004's actual budget deficit is likely to be around 8.6% of GDP. The current budget proposal aims to lower the deficit to 7.6% of GDP in 2005 and to 4.4% by 2008.

¶6. (U) Current projections are that GDP will grow by 5 - 5.5% in 2004. Inflation has been rising and the year-end rate is projected to exceed 7%, from around 6.3% in 2003.

¶7. (U) The current account deficit continues to put pressure

on the rupee, as does the absence of World Bank and IMF budgetary assistance in the overall balance of payments. Now that it has produced a "home grown" budget, without foreign assistance, the GSL has indicated it will begin discussions with the World Bank and IMF (Note: the budget relies on almost USD one billion in unspecified donor money for public investment projects. End note.). Some local bank contacts have projected a continuing depreciation of the rupee to around Rs 110/US$. The current rate is approximately Rs 104/US$.

Revenue

¶8. (U) The Value Added Tax (VAT) was widened to three tiers, from its current 15% rate. The new rates are 5% for essential food items, e.g. sugar, lentils, potatos, onions, milk powder, vegetables; 15% for standard items and services, and 18% for luxury items, e.g. liquor, air conditioners, refrigerators, washing machines, televisions, cameras, jewelry and motor vehicles (other than three wheel "baby taxis" and passenger buses). Certain imported inputs for the export sector, particularly the garment industry, will be exempt from VAT.

¶9. (U) The income tax structure was left largely unchanged, though the tax bands were widened and public sector employees will now be liable for income tax on half their gross income (any public sector employee found liable to pay taxes, however, will be given an equivalent tax allowance). The base income level for tax liability was also increased from Rs 240,000 (approximately US$2,400) to Rs 300,000 (approximately US$3,000) per year.

¶10. (U) The Economic Service Charge imposed by the previous government (a one percent tax on business turnover) was reduced to 0.5% for wholesale and retail trade, for both domestic and imported goods.

¶11. (U) The recently re-introduced 100% tax on land purchased by foreigners was left intact, though land to be used in the development of affordable housing projects, hospitals or large-scale public infrastructure will be exempt.

¶12. (U) Though corporate tax rates remain unchanged, corporate tax liability may rise, as numerous exemptions were removed or curtailed, including many standard deductions such as business expenses. This provision has been the subject of the most criticism by the business community.

¶13. (U) "Sin taxes" were increased, including additional excise taxes on liquor and an increased levy on betting and gaming.

¶14. (U) A new tax on NGOs was established. NGOs will be required to register with the Registrar of Companies and will be liable for a tax of 30% on 6% of funds received. This tax will reportedly apply to all NGOs, except those working in the North and East, or on other projects approved by the Minister.

¶15. (U) The VAT and income tax charges on profits from the sales of stocks will be replaced by a new 0.2% transaction tax on share trading. The tax will be assessed at the purchase and sale of shares. The Government has also pledged to repeal the retroactivity of a tax on gains from the sale of Government securities. The recently imposed tax had been retroactive to 2002 (Ref A).

16 (U) While no specific target date was set, Minister Amunugama pledged that fuel subsidies would be "phased out."

¶17. (U) New fees were proposed on the export of cinnamon and ferrous or nonferrous metals in any form (including scrap), and on total turnover of small and medium-sized contractors (to help fund a construction guarantee fund to assist the construction industry).

Tax Administration and Compliance Measures

¶18. (U) In an effort to improve revenue collection, the Minister proposed several reforms to the Inland Revenue Department, though all fell far short of the IMF and ADB-sponsored plans for a complete Department overhaul and consolidation of revenue authorities. The mostly administrative changes proposed in the UPFA budget include: establishment of an appeals unit; implementation of a tax charter outlining taxpayer rights; efforts to collect information on tax evaders; a requirement that all refunds made by the Inland Revenue Department be cleared by a newly appointed committee within one week; and, new dedicated tax courts. A Tax Ombudsman was also proposed to facilitate fair and expeditious settlement of grievances.

¶19. (U) With regard to tax compliance, the Minister noted that out of a working population of six million, only 200,000 people pay taxes. Several new measures to improve tax compliance will include withholding on certain large purchases, requirements that citizens who meet specified requirements with regard to credit card and utility bills open tax files, and a "gold card" for "honest taxpayers" which entitles bearers to special privileges (including a special lounge at the airport!). Finally, a tax clearance certificate will be mandatory for bidding on government tenders.

New Programs and Expenditures

Public Sector:
¶20. (U) The UPFA promised public sector workers a 70% pay hike during its campaign. The current budget proposal grants a 40% increase on current basic salaries to a maximum of Rs 9,000 (US$90) per month, for lower rank employees the actual raise is equivalent to the 70% promised. The increase will come over two years. Public servants will also get a comprehensive medical insurance program, access to Government-guaranteed housing loans up to US$ 10,000 and at least two weeks of training each year.

¶21. (U) Surpassing its campaign pledge to hire 27,000 unemployed graduates, the UPFA government actually hired 42,000 graduates, who will now become "service oriented change agents." The budget proposes an additional Rs 2.8 billion (US$ 28 million) to place these 42,000 recent hires into permanent positions, and Rs 1.1 billion (US$ 11 million) to hire an additional 30,000 high school graduates into government positions.

SME Bank:
¶22. (U) A cornerstone of the new budget is assistance to SMEs, primarily in the form of a newly constituted SME "bank." The "bank" will be established with a capital base of Rs. 5 billion (US$ 50 million) and will provide direct funds, credit guarantees, equity and debt capital and restructuring aid. Whether this will be a new bank or GSL program run through existing banks is yet unknown. Mano Tittawella, Senior Economic Advisor to the President, told Econchief that the funds would be used to provide guarantees, primarily through existing banks, to help diffuse the risk faced by banks when lending to SMEs with little collateral.

Infrastructure Development:
¶23. (U) New infrastructure programs proposed in the 2005 budget include: a three-year accelerated infrastructure development program in the nation's two poorest districts; a village-level development program for two districts to provide minor irrigation schemes, feeder roads, basic health facilities and transportation services; low income housing units in the plantation and fishing areas; and a seven year tax exemption on income from rental houses of less than 1500 square feet of floor area.

Apparel Sector:
¶24. (U) With the final phase out of the Multi-Fiber Agreement in January 2005, the apparel sector was a focus of the new UPFA budget. Assistance includes: Rs 600 million (US$ 6 million) for guarantees from the newly established SME bank to provide working capital and investment; exemption from VAT payments on the import of textiles and ancillary inputs; VAT-free services from the Garment Buying Office; a grant of Rs 200 million (US$ 2 million) for productivity improvement; Rs 100 million (US$ one million) to improve local designer training programs to expand domestic inputs to the overall value chain; and, establishment of an apparel-related industrial park in a free trade zone near Colombo. The new SME bank will also provide working capital to the developing textile industry and all textile requirements for government uniforms are to be procured locally.

Local Software Development:
¶25. (U) The budget proposes 100% depreciation on locally developed software in the year of purchase. The budget also stresses that the GSL will give priority to locally developed software in its software procurements (Note: several Sri Lankan software firms produce business application software. End Note.). In cases where certain applications are not developed locally, additional benefits are available to firms who use local value addition for imported software.

National Action Plan for Children:
¶26. (U) A fee of 0.25% will be assessed on certain taxes to suplement funds required to implement the National Action Plan for Children. The Plan is designed to ensure universal access for child-development services.

¶27. (U) Other programs include:

-- implementation of computer-linked resource centers in 320 Divisional Secretariat areas,

-- technical assistance for floricultural sector development,

-- assistance to the dairy industry, with the goal of self-sufficiency in dairy production,

-- assistance for organic product exports,

-- development of the value-added cinnamon industry,

-- incentives for the rubber industry,

-- incentives for the foundry industry (fee on the export of ferrous metals outlined above),

-- incentives for shrimp farming development,

-- development of model farms for fruits and vegetables,

-- employment creation and income generating projects for welfare recipients,

-- an initiative for the revival of the construction industry (including a new Academy for Advanced Construction Training to meet the growing need for skilled labor),

-- a housing loan scheme for returning overseas workers,

-- new fuel subsidies for three-wheel "baby taxi" operators and assistance for converting existing three wheelers from gasoline to natural gas.

Reactions to the Budget

¶28. (U) Local reaction to the budget has been generally positive, with many business groups lauding the government for not raising taxes further than they did and urging the Government to remain vigilant on cutting the budget deficit. All major Chambers of Commerce have hailed the budget, though Sri Lanka's premier business organization, the Ceylon Chamber of Commerce, has called for the removal of provisions that reduce business tax deductions (Note: several economists have commented to us that the larger chambers are happy because their proposals for protection for member industries were adopted. End note).

¶29. (SBU) Despite a budget that dramatically reverses many trends of the previous two years that were implemented by the UNP, reaction from the opposition has been largely muted. UNP complaints have largely been confined to a proposed requirement that an additional hour be added to the public sector work day in exchange for the pay raise (Note: news reports indicate that the GSL may make the extra hour "voluntary." End Note.). The UNP may be feeling constrained in its ability to criticize given the populist nature of many of the budget provisions.

Comment

¶30. (SBU) The 2005 budget proposal is receiving widespread praise primarily because it is not as bad as most people thought it would be. The Government's coalition partner, the Marxist Janatha Vimukthi Peramuna (JVP), got increased funding for its constituent areas, particularly with the rural and SME development provisions. Belying the emphasis on an increased Governmental role in the economy, the Minister's speech did pay lip service at least to the need for private sector partcipation in the economy. The Government's revenue projections are optimistic and the Finance Secretary has called budget implementation "a challenge."

¶31. (SBU) Being less bad than expected is not what Sri Lanka needed in its budget. The budget is an extension of the earlier Economic Policy Framework (EPF - Ref B) and continues to give the impression that the private sector is something akin to a necessary evil, while the Government must control the economy.

¶32. (SBU) Also worrying is the increase in protectionist sentiment and new tariffs. The Government wants to benefit from trade through exports but, rather than allowing imports to foster competition and push productivity and efficiency, the GSL sees only markets overseas and at home. A nation the size of Sri Lanka must utilize its comparative advantages that have driven growth for the past three years, such as continued focus on high-end, "niche" apparel markets, continued movement into IT back office operations and software development, focused development of export-quality agricultural products.

¶33. (SBU) During the recent TIFA talks in Washington, we understand the US side commented that Sri Lanka needs FDI (foreign direct investment) more than FTA (free trade agreement). We concur, and are concerned that this budget

does not provide sufficient incentive for foreign investors to take the risk of operating in Sri Lanka, and hobbles the local business community's ability to grow.

¶34. (SBU) The peace process remains an unknown. A continued ceasefire and progress in a return to the negotiating table could be a net benefit for Sri Lanka in any investment equation. Nonetheless, the GSL needs to complement the "peace front" with policies that attract investment and promote enhanced competitiveness. The current budget proposal does not fit the bill.

¶35. (SBU) Nonetheless, the budget here, as everywhere, is a very political exercise, and tremendous emphasis was placed on producing a "home grown" budget, without foreign assistance. There was also a need to produce something acceptable to the JVP faction in the coalition. Now that that exercise is behind them, we hope the GSL will be willing to reach out more broadly, and seek input from donors and the international community. Their approach to USG comments on their Millennium Challenge Account concept paper and possible upcoming meetings with the IMF and World Bank should help give an indication on this front. End Comment.
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